

**MEMO# 18801**

April 27, 2005

# **GAO REPORT REGARDING MUTUAL FUND TRADING ABUSES**

©2005 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [18801] April 27, 2005 TO: BOARD OF GOVERNORS No. 17-05 CHIEF COMPLIANCE OFFICER COMMITTEE No. 35-05 COMPLIANCE ADVISORY COMMITTEE No. 31-05 PRIMARY CONTACTS - MEMBER COMPLEX No. 16-05 SEC RULES MEMBERS No. 53-05 SMALL FUNDS MEMBERS No. 36-05 RE: GAO REPORT REGARDING MUTUAL FUND TRADING ABUSES The U.S. Government Accountability Office has issued a report to the House of Representatives' Committee on the Judiciary regarding the mutual fund trading abuses.\* The report, which responds to the Committee's requests concerning issues relating to regulatory oversight of the mutual fund industry, (i) identifies the reasons the Securities and Exchange Commission did not detect the abusive market timing agreements at an earlier stage and lessons learned from the SEC's failure to do so; and (ii) assesses steps that the SEC has taken to strengthen its mutual fund oversight, deter abusive trading, and improve mutual fund company operations. Report Overview The report found that prior to September 2003, SEC staff did not examine for market timing abuses or assess company controls over that activity because the staff (i) viewed market timing as a relatively low-risk area that did not involve per se violations; (ii) determined that mutual fund companies had financial incentives to establish effective controls over frequent trading because such trading can reduce fund returns resulting in a loss of business; and (iii) were told by company officials that they had designated compliance staff to monitor and control market timing. The report acknowledges that the SEC faced competing examination priorities prior to September 2003 and made good faith efforts to control known risks associated with market timing through the regulatory process, such as by issuing guidance on "fair value" pricing. \* See Mutual Fund Trading Abuses: Lessons Can be Learned from SEC Not Having Detected Violations at an Earlier Stage, GAO Report to the Committee on the Judiciary, House of Representatives (April 2005). Because undisclosed market timing arrangements were more widespread than late trading violations, the report primarily focuses on the SEC's oversight of the market timing area. The report also addresses the NASD's oversight of broker-dealers that failed to prevent customer's late trading and market timing activities. 2 Nevertheless, the report concludes that lessons can be learned to strengthen the SEC's mutual fund company oversight program going forward. In particular, the report states that conducting independent assessments of controls over various activities within a mutual fund company, including areas perceived to represent relatively low risks at a sample of companies, is, at a minimum, an essential means to verify assessments about risks and the adequacy of controls in place to mitigate those risks. The SEC can also strengthen its capacity to identify and assess evidence of potential risks. For example, articles in the financial press and academic studies that were available

prior to September 2003 stated that market timing posed significant risks to mutual fund company shareholders. Finally, the report found that fund company compliance staff often detected evidence of undisclosed market timing arrangements with favored customers but lacked sufficient independence within their organizations to correct identified deficiencies. The report recommends that ensuring compliance staff independence is critical and that the SEC could potentially benefit from their work.

### SEC Steps to Improve Compliance by Funds and Advisers

The report recognizes that the SEC has taken several steps to strengthen its mutual fund oversight program and the operations of mutual fund companies over the past two years, although it notes that it is too soon to assess the effectiveness of several key initiatives. To improve its examination program, the SEC has instructed examiners to make additional assessments of mutual fund company controls. For example, SEC staff has identified a range of areas that potentially represent high-risk compliance problems, such as personal trading by mutual fund company officials, and examiners have initiated independent examinations of these areas. To improve its capacity to anticipate, identify, and manage emerging risks and market trends in the securities industry, the SEC has created an Office of Risk Assessment. The report also notes that the SEC has adopted rules designed to improve mutual fund company operations, including rules that require funds and advisers to each designate a chief compliance officer. Finally, the report states that the SEC has adopted two specific rules designed to address market timing and is working on a rule designed to prevent late trading.

### Report Recommendations

Among other steps, the report recommends that the SEC's examination staff assess the independence and effectiveness of the CCOs required under the new SEC rule. The report also recommends that the SEC develop a plan to assess the feasibility of receiving and reviewing the new mutual fund annual compliance reports (or material findings in those reports) on an ongoing basis.

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